as well as the prior allowances, was based upon a rate so calculated that at the expiration of the lease the cost of the buildings would be extinguished by equal annual installments.

II. Facts bearing upon valuation of inventory

During 1918 the petitioner was engaged in manufacturing ammunition under four contracts with the United States, known as contracts (1) P6489–1489Sa, (2) 12621–3124A, (3) P12289–3034A, and (4) GA–126. One of these contracts was made in 1917 and the others on various dates in 1918 prior to November 11, 1918. (R. 67–68.) Each of the contracts contained a provision for cancellation by the Government in the event of the end of the war, and provided that in the event of the termination of the contract the Government would reimburse the petitioner for the cost of worked and unworked materials then on hand and other expenses incurred in connection with its commitments under the contracts. (R. 126, 142, 154, 170.)

In December, 1918, the Government notified the petitioner to suspend production under these contracts, each notice stating that the request was made with a view of negotiating a supplemental contract providing for the cancellation, settlement, and adjustment of the existing contract in a manner which would permit of a more prompt settlement of payment than would be practicable under the existing contract. (R. 69.) Pursuant

to these notices the petitioner suspended production under the contracts. (R. 70.)

Negotiations for settlement under the contracts were begun early in 1919. In March and April, 1920, supplemental contracts were executed between the petitioner and the United States with reference to each of the original contracts, except contract P6489–1489Sa. These supplemental contracts each provided for a method of determining the amounts to be paid to the petitioner on account of suspension of production under the contracts. (R. 71, 174–184, 201.) Contract P6489–1489Sa, executed May 6, 1918, was supplemented by an agreement made December 18, 1918, which was not executed in compliance with the statutory requirements. The War Department treated the original contract, as so amended, as within the provisions of the Act of March 2, 1919, known as the Dent Act (c. 94, 40 Stat. 1272), and settled the contract and its amendment under procedure established to cover contracts not executed in accordance with statutory requirements. (R. 71, 132–134.)

In 1920 the United States took over the greater part of the petitioner's worked and unworked material under these contracts, and then paid petitioner the cost of all raw material, whether unworked or in the worked material, but nothing for the cost of labor and overhead expense incurred by the petitioner in connection with the worked materials. (R. 71.) In 1921 and 1922 final settlement of the

contracts was effected, by which the Government reimbursed the petitioner for the cost of labor and overhead on the material previously delivered to it, and for the cost of the remaining portions of its inventory or for a part of this cost less the salvage value of such portions, and in the latter case the petitioner retained the material for which it had been so reimbursed. (R. 75.)

The fair market value of the worked and unworked materials which the petitioner had on hand on December 31, 1918, applicable to the contracts here involved, without considering any special value arising from obligations of the United States, was $231,615.43. (R. 76.) The value of these materials on that date, pricing at cost those which were subsequently taken over at cost by the United States, pricing the materials for which the petitioner was paid a part of the cost at the amount which was received therefor under the settlement contracts, and pricing the remainder at the fair market value on December 31, 1918, was $732,088.62. (R. 76.) In valuing the petitioner's inventory at the end of 1918 for the purpose of determining the petitioner's 1918 taxes, the Commissioner valued the materials in question at $732,088.62 (R. 76) and rejected the petitioner's contention that they should have been valued at $231,615.43. (R. 77.) Any reduction in the inventory below $732,088.62 would cause an equal reduction in the petitioner's taxable income for 1918. (R. 77.) The petitioner kept its accounts and

made its returns for the calendar year upon the accrual basis. (R. 59.)

The Court of Claims held that the Commissioner did not err either in fixing the allowance for exhaustion of the leased buildings or in the valuation of the petitioner's inventory. (R. 96–110.)

SUMMARY OF ARGUMENT

In computing petitioner's income and profits tax for the years 1914 to 1924, inclusive, the Commissioner allowed a deduction in each of those years, in respect of petitioner's investment in the buildings on leased land, of an amount equal to the total cost of the buildings divided by the number of years of the lease. Under this method there was returned to the petitioner in equal annual installments the full cost of the buildings by the time the lease expired. This procedure, we contend, is in accord with the law and regulations.

The petitioner contends that since the buildings were constructed solely for war uses, which ended with the signing of the Armistice, and since they were not profitably employed during the remainder of the term, it is entitled to charge off in 1918 as obsolescence an amount representing the difference between the depreciated cost of the buildings as of January 1, 1918, and the value, as of December 31, 1918, of the right to use the buildings for the remainder of the term of the lease. It bases this right upon the general provision in Section 234 (a) (7) in the Revenue Act of 1918 for a deduc-

tion of "a reasonable allowance for obsolescence" and the construction of that language by this Court in *Burnet* v. *Niagara Falls Brewing Co.*, 282 U. S. 648. But it should be borne in mind that "obsolescence" was expressly mentioned in no Revenue Act prior to that of 1918, and to determine the scope of the word we must look at other provisions of that Act. Paragraph (8) of the same section permitted "a reasonable deduction for the amortization of such part of the cost" of buildings, etc., constructed on and after April 6, 1917, "for the production of articles contributing to the prosecution of the present war." The fact that Congress provided for such a deduction for amortization only of buildings and other facilities constructed on and after April 6, 1917, indicates clearly that it did not intend to allow such a deduction to taxpayers whose buildings were erected to furnish war supplies to the European nations before the United States entered the conflict. The legislative history of this provision indicates that Congress contemplated that no other provision of the Act allowed a deduction on account of loss of value of war factories due to the end of the war.

Even if the statute should be construed to extend to obsolescence of munition factories constructed prior to April 6, 1917, caused by the Armistice, we submit the facts here do not establish any basis for such obsolescence during 1918. The mere fact that the value of the petitioner's interest in the buildings declined suddenly at the end of 1918 does not

establish obsolescence. They were readily adaptable to petitioner's ammunition and other businesses, and were so used. The mere fact that these businesses turned out not to be profitable is not significant.

The Commissioner did not err in the valuation which he placed upon the petitioner's inventory as of December 31, 1918.

The statute and applicable regulations were designed to prevent deductions for losses through inventory valuations when the taxpayer was secured against such losses. The Commissioner promulgated a regulation pursuant to a statutory mandate in regard to inventories, and construed this as providing that in the instant case material for which the Government was compelled to pay the cost should be inventoried at cost, even though a taxpayer generally may take his inventory at cost or market, whichever is lower. Here the contracts of the taxpayer assured it that it would be reimbursed for the cost of material which was not completed at the time of the cancellation of the contracts. Even if this provision did not render the contracts "firm sales contracts" within the strict meaning of the regulations, it would be a distortion of income to value goods at $231,000 where they actually cost over $700,000 and the Government was obliged to pay for them at cost. If the provision in the regulations relating to "firm sales contracts" is not applicable, nevertheless it was the duty of

the Commissioner to require an inventory which would reflect true income.

The contention of the petitioner that the contracts guaranteed no reimbursement of the cost of materials after suspension notices had been sent in 1918 is not supported by the facts.

In determining the cost figures for petitioner's inventory as of December 31, 1918, it was proper for the Commissioner to consider the payments made by the Government, as they represented the ascertainment of the cost of the inventory.

ARGUMENT

I

IN COMPUTING ITS TAXABLE INCOME FOR 1918, THE PETITIONER WAS NOT ENTITLED TO A DEDUCTION IN RESPECT OF THE BUILDINGS ERECTED BY IT UPON LEASED LAND IN EXCESS OF THE DEDUCTION ALLOWED BY THE COMMISSIONER

The buildings in question were constructed by the petitioner on leased land during the years 1914, 1915, and 1916,[1] under an agreement providing that the petitioner should have the right to use the buildings for ten years from January 1, 1915, paying no rent to the lessor, and at the end of the ten years they should become the property of the lessor. The right of the petitioner to use the buildings, therefore, ended December 31, 1924.

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[1] Only $72.21 was spent on building construction during 1917. (R. 78.)

As has been stated, in computing petitioner's income and profits tax for the years 1914 to 1924, inclusive, the Commissioner allowed a deduction in each of those years, in respect of petitioner's investment in the buildings, of an amount equal to the total cost of the buildings divided by the number of years of the lease. Under this method there was returned to the petitioner in equal annual installments the full cost of the buildings by the time the lease expired. This procedure, we contend, is in accord with the law and regulations. Article 109, Reg. 45 (p. 38, *infra*); *National City Bank of Seattle* v. *The United States*, 64 C. Cls. 236; certiorari denied, 276 U. S. 620. See *Duffy* v. *Central R. R. of New Jersey*, 268 U. S. 55, 64.

The petitioner contends that the change of circumstances produced by the termination of the war in 1918 justifies a deduction in 1918 on account of its investment in the buildings on a wholly different basis. It contends that since the buildings were constructed solely for war uses, which ended with the signing of the Armistice, and since they were not profitably employed during the remainder of the term of the lease it is entitled to charge off in 1918 as obsolescence an amount representing the difference between the depreciated cost of the buildings as of January 1, 1918, and the value as of December 31, 1918, of the right to use the buildings for the remainder of the term of the lease. If petitioner's contention is sound it is entitled to a deduction of $414,421.89 from its gross income for

1918 instead of $86,484.54, the amount allowed by the Commissioner of Internal Revenue.

We concede that there was an unusual decline in the value of the buildings during 1918, and do not dispute the finding of the Court of Claims that the value of the petitioner's right to use them during the remaining six years of the lease was $190,969.86. (R. 82.) But we contend that the method of allowing the deductions adopted by the Commissioner is correct and that the petitioner is not entitled to a greater deduction on account of obsolescence. As it is well settled that a taxpayer has a right to take only such deductions as are expressly allowed by the statute, the question is simply what statutory provision is applicable to the situation. See *Botany Mills* v. *United States*, 278 U. S. 282. The petitioner relies upon Section 234(a) (7) of the Revenue Act of 1918, which provides:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

It argues that this provision for obsolescence is applicable and relies upon the decision of this Court in *Burnet* v. *Niagara Falls Brewing Co.*, 282 U. S. 648, which upheld deductions for 1918 and 1919 for obsolescence of brewery property caused by prohi-

bition legislation, although the taxpayer continued to use part of the property until 1921 in another enterprise. We submit that that decision is not controlling. If paragraph (7) (quoted above) alone were involved, it would indeed be arguable that Congress intended to provide for an allowance for obsolescence even in such a case as this. But it should be borne in mind that "obsolescence" was expressly mentioned in no Revenue Act prior to that of 1918,[2] and to determine the scope of the word we may look at other provisions of that Act.

Immediately after the provision for obsolescence in Section 234 is a provision permitting deductions:

> (8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, * * * there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. * * *

The fact that Congress allowed for such a deduction for such "amortization" only in the case of buildings and other facilities constructed on or

[2] See *Gambrinus Brewery Co.* v. *Anderson*, 282 U. S. 638, 643–644.

after April 6, 1917, indicates clearly that it did not intend to allow such a deduction to taxpayers whose buildings were erected to furnish war supplies to the European nations before the United States entered the conflict. *Manville Jenckes Co.* v. *Commissioner,* 4 B. T. A. 765, 789–791. As this Court indicated in *Ford* v. *United States,* 273 U. S. 593, 611, the doctrine, *"Expressio unius est exclusio alterius"* applies "when in the natural association of ideas in the mind of the reader that which is expressed is so set over by way of strong contrast to that which is omitted that the contrast enforces the affirmative inference that that which is omitted must be intended to have opposite and contrary treatment."

The legislative history of Section 234 (a) (8) indicates, also, that Congress did not intend to allow a taxpayer situated like the petitioner to deduct a loss caused by the unexpected termination of the war and its war business. In proposing the new deduction for the Revenue Act of 1918, the Committee on Ways and Means reported (House Report 767, 65th Congress 2d Session, at page 10):

> (4) Due to the necessity for erecting buildings and building machinery for war purposes many buildings and much machinery have been erected that will be of little value after the war. Under existing law it is impossible for the Treasury Department to allow deductions other than for the ordinary exhaustion, wear and tear, and depletion of such property. A provision is in-

corporated in this bill to allow the Treasury Department in such cases to allow special amounts for amortization, according to the peculiar condition in each case, but such amounts can not exceed in any year 25 per cent of the net income.

The petitioner's reliance upon Section 234 (a) (4) and 234 (a) (7) of the Revenue Act of 1918, as interpreted by the applicable Regulations, as a basis for the allowance of the deductions claimed by it, is in effect an attempt to gain the benefits of Section 234 (a) (8) without meeting the requirements of that section. Section 234 (a) (8) defines the right which petitioner asserts and places limitations thereon which exclude the petitioner from its enjoyment.

Even if the statute should be construed to extend to obsolescence of munition factories constructed prior to April 6, 1917, caused by the Armistice, we submit that the facts here do not establish the basis for such obsolescence during 1918. For we conceive of obsolescence not as a mere decline in value, but as a condition by which property approaches the state of permanent uselessness.[1] Mere loss in value of physical assets because of a lack of available willing purchasers is not obsolescence. Thus depreciation in values, due to a panic or an economic deflation, does not constitute

[1] Cf. *Burnet* v. *Niagara Brewing Co.*, *supra*, 282 U. S. 648, 653–654.

obsolescence. The finding of the court as to the diminished value at the end of 1918 does not establish obsolescence.

We submit that the instant case does not present a situation parallel to that involved in the *Niagara Falls Brewing case, supra.* There it became apparent to the taxpayer in 1918 that, because of prohibition legislation, it would soon be required to abandon forever the use of its property for the purpose for which it was acquired. That property was designed and constructed for the brewing of beer and was not available or readily adaptable to other uses. After prohibition became effective, a portion of the property was abandoned and the remainder was used to a limited extent for a brief time in the manufacture of near beer.

It is true that when the petitioner erected the buildings it had no use for them except for war purposes. But the termination of the war did not prohibit the petitioner from using the buildings for the remainder of the term of the lease for the purpose for which they were constructed. The buildings which had been used for the production of war materials were readily adaptable, apparently at little or no expense, to the petitioner's commercial ammunition business. Although after the war the petitioner had more space, in its new and old buildings, than it needed for its commercial ammunition business, it continued to use the new buildings for the manufacture of new products. None of the buildings was discarded or abandoned. Al-

though the petitioner made no profit in its new businesses in the years immediately following the war, this fact would not seem to be of much significance since it was not apparent at the end of 1918 that it would not make profits in the future. In the short time between November 11, 1918, and the close of the year 1918, it was hardly in a position to predict this. While it was reasonable for it to expect that it would not enjoy the same degree of prosperity from its peace-time business as it did from its war business, it obviously had no way of knowing that it would not be able to employ the use of its buildings for the remainder of the term of the lease to its advantage. It is common knowledge that business generally in this country in the post-war period, except for a time in about 1921, was very prosperous. It is well known that many manufacturing companies which had engaged in the manufacture of munitions during the war were able to adapt their plants to other uses and prospered greatly in peace-time production. The petitioner's buildings were for the most part of brick and concrete construction and were readily adaptable to other uses, as evidenced by the fact that it manufactured such articles as radiators, motors, and paper boxes in addition to ammunition, in the post-war period. Of course the rental value of such properties was greatly depreciated and this is reflected in the value of petitioner's right to use them for the unexpired term of its lease. They were, however, as fit and quite as available for such

use as they ever were. The effect of prohibition upon brewing plants was different. Their property was peculiarly adaptable to a single line of manufacture, and the probability of converting the property to other profitable uses was extremely remote. The Court of Claims aptly distinguished the petitioner's situation from the situation of the brewers, when it said (R. 109):

> * * * It (the petitioner's case) is in all respects similar to a case wherein a business enterprise enjoying prosperity finds enlarged quarters essential to meet its demands, and without knowledge as to any exact date when an intervening incident may curtail its income, such as bad times, termination of a war, drought, etc., income is materially reduced or disappears, and the enlarged quarters are no longer essential for the needs of the corporation during this period of distress. Under these circumstances what may happen to the buildings during the remaining period of the lease is problematical and is distinctly different from a case where legislation prohibits the future use of the buildings for the purposes erected, and for which purpose they were specially designed and constructed and not "readily adaptable to other uses." * * *

Indeed, it would seem to be only a short step from the contention of the petitioner to the contention that obsolescence or loss for tax purposes is incurred in any case where there is a sudden drop in the demand for the productive use of property.

If in good times a taxpayer expands his plant, he should not be allowed a deduction for obsolescence when on account of some unforeseeable event, such as the present depression, he finds that his business does not require the use of his whole plant. The income tax laws do not provide that such fluctuating conditions give rise to deductible losses. Articles 143, 144 of Regulations 45 (p. 40, *infra*); *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109, 116. See also *United States* v. *White Dental Co.*, 274 U. S. 398, 401, where this Court stated:

> The statute obviously does not contemplate and the regulations (Art. 144) forbid the deduction of losses resulting from the mere fluctuation in value of property owned by the taxpayer.

II

IN COMPUTING PETITIONER'S TAXABLE INCOME FOR 1918 THE COMMISSIONER DID NOT ERR IN THE VALUATION WHICH HE PLACED UPON THE PORTION OF PETITIONER'S INVENTORY ON HAND AT DECEMBER 31, 1918, WHICH CONSISTED OF MATERIAL ACQUIRED FOR USE IN CONNECTION WITH ITS CONTRACTS WITH THE UNITED STATES

A. The statute and applicable regulations were designed to prevent deductions for losses through inventory valuations when a taxpayer was secured against such losses

Section 203 of the Revenue Act of 1918 (p. 34, *infra*), provides two tests for every inventory, (1) it must conform as nearly as may be to the best

accounting practice applicable to the trade or business involved, and (2) it must clearly reflect the income. Furthermore, this section delegates to the Commissioner of Internal Revenue the duty and power to make such regulations relating to the basis upon which inventories shall be valued, as, in his opinion, conform to these two tests. It is established that regulations promulgated pursuant to such a statutory mandate have the force of law and are as binding upon the courts as if incorporated in the statute itself.

Articles 1581 to 1584, inclusive, of Regulations 45, as amended by Treasury Decision 3296, C. B. I–1, p. 40 (pp. 36–38, *infra*), recognize two general methods of valuing inventories: (1) Cost, and (2) cost or market, whichever is lower. An inventory taken under method (1) on the basis of the cost price of merchandise has the effect of deferring any gain or loss on such merchandise until it is actually disposed of. Where method (2) is adopted, and market value is lower than cost, the effect is to bring into the account a loss which may never be realized.

Article 1584 (*infra,* p. 37), recognizes the necessity for an exception to the general method (2), that merchandise be inventoried at cost or market, whichever is lower, for it provides:

> * * * Goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to

> cancellation by either party) at fixed prices entered into before the date of the inventory * * * must be inventoried at cost.

The purpose and intent of this regulation was considered by the United States Board of Tax Appeals in *Mutual Chemical Company of America* v. *Commissioner,* 12 B. T. A. 578. The Board, holding that the inventory composed of raw materials was for delivery on a firm sales contract and should be valued at cost, said:

> The purpose of the regulations promulgated under that section of the Act of allowing taxpayers to compute inventories on the basis of cost or market, whichever is lower, as distinguished from the cost basis, is to allow an accounting for any reduction in the value of the inventory which has in fact taken place during a taxable year, thereby more clearly reflecting income. Where the inventories on hand, whether in the form of raw materials, goods in process, or finished goods, are required to fulfill legally enforceable contracts, it is obvious that the taxpayer is protected against any reduction in value occasioned by declining market prices; and to allow a taxpayer where he is protected by sales contracts at a price in excess of cost or market, to inventory those items at market, would distort his income in that he would show a loss in one year when in fact none was sustained and a greater gain than the true gain in the following year when the sales were executed.

It appears from this decision that the object of the Treasury in promulgating this regulation was to avoid an inaccurate reflection of income through improper inventory deductions. It seems evident that where a taxpayer has legally enforcible assurance that he will be paid the cost of his inventory, then such inventory must be taken at cost rather than at a figure which must reflect a loss which he has not and can not suffer. To apply a market price lower than cost in such a case distorts the actual income and defeats the general purpose of the statute.

B. The contracts in question secured the petitioner against loss on account of the cost of its inventory of raw materials and work in process, within the meaning of the regulations

On December 31, 1918, the petitioner had on hand a large quantity of raw materials and work in process intended for use under its four contracts with the United States. These contracts had been suspended after the Armistice, and on December 31, 1918, the general market value of the materials was $231,615.43. But the contracts provided for the petitioner's reimbursement for the cost of the materials.

There were four such contracts, known as (1) P12621–3124A, (2) P6489–1489Sa, (3) P12289–3034A, and (4) GA–126. Contract P12621–3124A contained the following provision (R. 163, 170):

ARTICLE XIV. *Termination.*—This contract being necessitated by a state of war now existing, it is desirable and expedient that provision be made for its cancellation upon fair and equitable terms in the event of the termination or limitation of the war, or if in anticipation thereof or because of changes in methods of warfare the Chief of Ordnance should be of the opinion that the completion of this contract has become unnecessary. It is therefore provided that at any time and from time to time, during the currency of this contract, the Chief of Ordnance may for any of the causes above stated notify the Contractor that any part or parts of the articles then remaining undelivered shall not be manufactured or delivered.

In the event of such complete or partial termination the United States shall inspect all completed articles then on hand and such as may be completed within thirty (30) days after such notice and shall pay to the Contractor the price herein fixed for all articles accepted by and delivered to the United States. The United States shall also pay to the contractor the cost of the materials and component parts purchased by the contractor for the performance of this contract and then on hand in an amount not exceeding the requirements for the completion of this contract provided they comply with the specifications, and also all costs shown by the contractor to have been theretofore necessarily incurred in the performance of this contract and remaining unpaid;

> and the United States shall also protect the Contractor on all obligations incurred necessarily and solely for the performance of this contract of which the Contractor can not be otherwise relieved. To the above may be added such sums as the Chief of Ordnance may deem necessary to fairly and justly compensate the Contractor for work, labor and service rendered under this contract.

The three other contracts each contained a similar provision, except that contract GA–126 did not give petitioner the right to continue production for thirty days after notice of termination. (R. 153, 141, 125.) Although the contracts were not formally canceled, work under them was suspended upon demand by the United States, and, we submit was "terminated" within the meaning of that word as used in the contracts.

The petitioner contends that these contracts were not "firm sales contracts," within the meaning of Article 1584—i. e., "those not legally subject to cancellation"—and that therefore that Article does not require the inventory to be valued at cost. A strict, literal reading of the regulation lends some support to this position. Although these contracts were subject to cancellation or termination, the contractor was guaranteed full reimbursement for the cost of raw materials and work in process in that event. Consequently the contractor was firmly assured by contract that cancellation would not inflict on it a loss in respect of the materials on hand. Evidently the purpose of the regulation

was to prevent the deduction of "inventory losses" if because of contractual obligations such losses could not become actual. The clause permitting cancellation or termination of these contracts did not take them out of the class of "firm sales contracts" for it was coupled with an assurance of payment of the cost of the materials. The effect of the contracts was to establish (1) a fixed price if the goods were completed and (2) repayment of the cost if the work was not completed. This was a firm contractual obligation to buy the finished product or upon cancellation to pay the cost of materials.

The petitioner's situation is precisely analogous to the situation covered by the regulation, and the Commissioner's valuation of the inventory should not be revised. His interpretation of the regulation which he promulgated is entitled to great weight. Evidently he believed that the contracts in this case were "firm-sales contracts," in spite of the cancellation clause, when he valued the inventories at cost. Such a ruling, in conformity with the intent of the statute and regulation, should not be upset even if inconsistent with the narrow definition used in the regulation. Article 1584 obviously was not intended to provide expressly for every situation, as is shown by the fact that it begins with the words "under ordinary circumstances," and that Article 1582 (p. 36, *infra*) seems to contemplate that the Commissioner should be allowed some discretion and that the tax-

payer should not be granted the absolute right to adopt the basis of "cost or market, whichever is lower," for inventories prior to the year 1920. It may well be that the regulations contain no express provision covering the unusual situation in the instant case. If so, it was the duty of the Commissioner to determine the proper basis for determining the value of the inventory, and his decision in this case seems to be consistent with the general theory underlying the regulations. One of the fundamental tests for each inventory is that "it must clearly reflect the income" (Article 1582, p. 36, *infra*), and other provisions of the regulations seem to contemplate that goods can not be inventoried at a nominal value merely because the general market value is nominal, if they are being manufactured for a solvent customer who is under obligations to pay a substantial price for them. An inventory fixing the value of goods at $231,000 would not clearly reflect the income where the goods actually cost over $700,000, and the Government was under obligation to pay for them at cost.

The petitioner further contends that, whether the contracts were "firm-sales contracts" or not when executed, they guaranteed no reimbursement of the cost of materials after the suspension notices had been sent in December, 1918. It argues that work was not terminated in pursuance of the termination clauses of the contracts. The facts of the case do not support such position.

The contracts provided that the Chief of Ordnance might notify the contractor that any articles then undelivered should not be manufactured or delivered. This is just what the Chief of Ordnance did. His cause for the suspension notice was "the termination of the war," one of the causes mentioned in the contract. The petitioner did not insist upon its rights under the provision allowing manufacture for thirty days after the notice. By not so insisting it waived its rights to profits which it would have made by completing some more of the articles. *Savage Arms Corporation* v. *United States,* 266 U. S. 217; *Dorris Motor Car Co.* v. *United States,* 60 C. Cls. 68, affirmed 271 U. S. 96. But it did not thereby lose its right under the contracts to recover the cost of materials on hand. That right was guaranteed by the very clauses of the contracts under which the Chief of Ordnance acted in terminating the work. The suspension notices did refer to supplemental contracts to be negotiated. These were to amplify the rather brief provisions of the original contracts as to the payments of the cost of materials which of course remained in force unless and until varied by such supplemental contracts.

The petitioner attempts to show that the situation in this case after the receipt of the suspension notices was like that in *College Point Boat Corporation* v. *United States,* 267 U. S. 12. There the contract contained no cancellation clause, as do all the contracts in the instant case. The Navy De-

partment, unaware of its right to cancel the contract under the Act of June 15, 1917, requested the contractor to stop work. This Court held that in a suit for damages for the breach of the contract, the damages recoverable were limited by the existence of the right of cancellation, and that anticipated profits were not recoverable any more than in a suit for just compensation for loss because of cancellation. Of course the plaintiff's right to recover the cost of materials was not questioned, and the plaintiff in fact was paid such costs. The case is not in point, for in it operations were not ordered suspended pursuant to a termination clause in the contract; but it indicates that even if the present contracts had not specifically provided for the recovery of costs upon termination, the taxpayer would undoubtedly have been certain to recover either as just compensation, or as damages for a breach, the costs of the worked and unworked materials. See also *De Laval Steam Turbine Company* v. *United States,* No. 6, October Term, 1931, decided November 23, 1931. The petitioner was always assured of receiving the cost of the material, and therefore it would result in a misstatement of 1918 income to value the materials as of December 31, 1918, at less than cost.

C. In determining the cost figures for petitioner's inventory as of December 31, 1918, subsequent events may be considered

The petitioner urges that the respondent should not be permitted to consider events which occurred

after December 31, 1918, and value its inventory on the basis of payments received therefor in 1920, 1921, and 1922. The Government contends that this is permissible. The regulations require an inventory of this nature to be priced at cost. The payments received in the later years represent the *ascertainment of the cost* of this inventory. The record discloses only one specific instance in which the petitioner was not reimbursed for actual cost (Finding 34, R. 72–73), and in that case the goods were included in the inventory at the amount received therefor (Finding 41, R. 76–77.)

The petitioner filed its return for 1918 upon the accrual basis. (R. 59.) If on December 31, 1918, the petitioner had been unable to determine the exact cost of the inventory, it would have been permitted in its original return for 1918 to take the estimated cost of the inventory, and later, when the cost had been definitely ascertained, to file an amended return. Clearly, an inability to determine the accurate cost at December 31, 1918, does not create the right to inventory the merchandise on some other basis.

In the instant case the Commissioner's determination of the value of the materials, as of December 31, 1918, was not made until after the settlement contracts had been executed. The time for assessing the petitioner's taxes for 1918 had not then expired. (R. 59–60.) In determining, in 1925, the value as of December 31, 1918, of the materials, the Commissioner was not warranted in ignoring in-

tervening events having a legitimate bearing upon the value of the materials. The payment of the sums in question to the petitioner by the United States as the cost of the materials was the best evidence of such value available to the Commissioner. The Court below said (R. 98):

> It is of course true that at the close of the year 1918 the plaintiff was unaware as to the precise sum it would receive in dollars and cents for the materials on hand, the ascertainment of the same was yet to be made and the final result dependent upon accounting. It did, however, possess an enforceable demand for their cost in the form of a positive covenant to pay the same from a responsible party, and having voluntarily waived its right to have its tax liability for the year 1918 determined within the period of the statute of limitations with respect thereto, thereby enabled the exact determination of the cost of its inventory free from any uncertainty. The fixed statutory period within which the commissioner must determine a taxpayer's liability is a period which Congress extended to him to ascertain liability, and the ascertainment of the same is to be accomplished from the taxpayer's return.

In similar cases subsequent events are considered in ascertaining the true amount of a taxable gain from a sale at a tardily determined purchase price (*McCreery* v. *Commissioner*, 4 B. T. A. 967, 979–980) and in ascertaining the true amount of a deduction for a business loss through an admitted lia-

bility to pay unliquidated damages for breach of contract (*Producers Fuel Co.* v. *Commissioner*, 1 B. T. A. 202). See also *Inland Products Co.* v. *Blair* (C. C. A. 4th), 31 F. (2d) 867; *Acme Coal Co.* v. *United States*, 70 C. Cls. 696.

CONCLUSION

The decision of the Court of Claims is correct and should be affirmed.

Respectfully submitted.

THOMAS D. THACHER,
Solicitor General.
CHARLES B. RUGG,
Assistant Attorney General.
CLAUDE R. BRANCH,
Special Assistant to the Attorney General.
FRED K. DYAR,
BRADLEY B. GILMAN,
Attorneys.

C. M. CHAREST,
General Counsel,
Bureau of Internal Revenue.
ISADORE GRAFF,
Special Attorney,
Bureau of Internal Revenue,
Of Counsel.

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APPENDIX

STATUTES AND REGULATIONS

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1077, 1078, provides in part:

> SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.
>
> * * * * *
>
> SEC. 234. (a) That in computing the net income of a corporation subject to tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;
>
> * * * * *

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war, there shall be allowed a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time within three years after the termination of the present war the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the taxes imposed by this title and by Title III for the year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

* * * * *

Articles 1581, 1582, and 1584 of Treasury Regulations 45, as amended March 3, 1922 (C. B. I–1, pp. 40–41, 42), promulgated under Section 203 of the Revenue Act of 1918, provide as follows:

> ART. 1581. *Need of inventories.*—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption or use in productive processes, together with all finished or partly finished goods. Only merchandise title to which is vested in the taxpayer should be included in the inventory. * * *
>
> ART. 1582. *Valuation of inventories.*—The Act provides two tests to which each inventory must conform—(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation, so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the Revenue Act is (a) cost or (b) cost or market, whichever is lower. (For inventories by dealers in securities, see art. 1585.) * * *

In respect to normal goods, whichever basis (a) or (b) is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (a) cost or (b) cost or market, whichever is lower, for their 1920 inventories, and the basis adopted for that year is controlling and a change can now be made only after permission is secured from the Commissioner. * * *

* * * * *

ART. 1584. *Inventories at market.*—Under ordinary circumstances, and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases (a) of goods purchased and on hand, and (b) of basic elements of cost (materials, labor and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market exists or where quotations are nominal due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by

the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less proper allowance for selling expense, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market. It is recognized that in the latter part of 1918, by reason among other things of governmental control not having been relinquished, conditions were abnormal and in many commodities there was no such scale of trading as to establish a free market. In such a case, when a market was established during the succeeding year, a claim may be filed for any loss sustained in accordance with the provisions of section 214 (a) 12 or section 234 (a) 14 of the statute. See articles 261–268.

Article 109 of Treasury Regulations 45, promulgated under Section 234 (a) (1) of the Revenue Act of 1918, provides as follows:

ART. 109. *Rentals.*—Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being de-

ductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvement made, this deduction shall take the form of an allowance for depreciation.

Articles 141 and 143 of Treasury Regulations 45, promulgated under Section 234 (a) (4) of the Revenue Act of 1918, provide as follows:

ART. 141. *Losses.*—Losses sustained during the taxable year and not compensated for by insurance or otherwise are fully deductible (except by nonresident aliens) if (a) incurred in the taxpayer's trade or business, or (b) incurred in any transaction entered into for profit, or (c) arising from fires, storms, shipwreck or other casualty, or from theft. They must usually be evidenced by closed and completed transactions. In the case of the sale of assets the loss will be the difference between the cost thereof, less depreciation sustained since acquisition, or the fair market value as of March 1, 1913, if acquired before that date, less depreciation since sustained, and the price at which they were disposed of. See section 202 of the statute and articles 39–46 and 1561. When the loss is claimed through the destruction of property by fire, flood,

or other casualty, the amount deductible will be the difference between the cost of the property or its fair market value as of March 1, 1913, if acquired before that date, and the salvage value thereof, after deducting from such cost or such value as of March 1, 1913, the amount, if any, which has been or should have been set aside and deducted in the current year and previous years from gross income on account of depreciation and which has not been paid out in making good the depreciation sustained. But the loss should be reduced by the amount of any insurance or other compensation received. See articles 49 and 50. A loss in the sale of residential property is not deductible unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit. Losses in illegal transactions are not deductible. Where a person gives away property, or is divested thereof by death, no realization of loss results therefrom.

ART. 143. *Loss of useful value.*—When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in the business, he may claim as a loss for the year in which he takes such action the difference between the cost or the fair market value as of March 1, 1913, of any asset so discarded (less any depreciation sustained) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property must be prematurely discarded, as, for example, where an increase in the cost

of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. But see articles 181–189.

Articles 161, 164, and 165 of Treasury Regulations 45, promulgated under Section 234 (a) (7) of the Revenue Act of 1918, provide as follows:

ART. 161. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the useful life of the property in the business will

suffice, with the salvage value, at the end of such useful life to provide in place of the property its cost, or its value as of March 1, 1913, if acquired by the taxpayer before that date.

ART. 164. *Capital sum recoverable through depreciation allowances.*—The capital sum to be replaced by depreciation allowances is the cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions, and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition. Where the lessee of real property erects buildings, or makes permanent improvements which become part of the realty and income or loss has been returned by the lessor as a result thereof, as provided in article 48, the capital sum to be replaced by depreciation allowances is held

to be the same as though no such buildings had been erected or such improvements made.

ART. 165. *Method of computing depreciation allowance.*—The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of production. Whatever plan or method of apportionment is adopted must be reasonable and should be described in the return.

Articles 183 and 184 of Treasury Regulations 45, promulgated under Section 234 (a) (8) of the Revenue Act of 1918, provide as follows:

ART. 183. *Property cost of which may be amortized.*—The taxpayer may deduct from gross income a reasonable allowance for amortization; such deduction not to be in excess of the cost of buildings, machinery, equipment or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, or of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of the present war.

In the case of property the construction, erection, installation, or acquisition of which was commenced before April 6, 1917, and completed subsequent to that date, amortization will be allowed with respect only to that part of the cost incurred on or after April 6, 1917, and which was properly entered on the books of the taxpayer on or after that date.

ART. 184. *Cost which may be amortized.*—The total amount subject to amortization shall be the difference between the original

cost of the property if constructed, erected, installed, or acquired on or after April 6, 1917; or if acquired partly before and partly after April 6, 1917, then that part of the cost incurred on or after April 6, 1917, and properly entered on the books of the taxpayer on or after that date, less any amounts deducted for depreciation, losses, etc., prior to January 1, 1918, and the value of the property on either of the bases indicated below:

(1) In the case of property useful to the taxpayer only during the period of its operation as a war facility and which has been sold or permanently discarded, or which will be sold or permanently discarded within three years after the termination of the war; the value shall be the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded, such fair market value to be reestablished at and as of the time of the investigation by engineers of the Bureau of Internal Revenue.

(2) In the case of property not included in (1) above, the value shall be the estimated value to the taxpayer in terms of its actual use or employment in his going business; such value to be not less than the sale or salvage value of the property: *Provided however,* That for the purposes of returns made in 1919, the preliminary estimate of the amount of such amortization shall not, in any case, have exceeded 25 per cent of the cost of the property. In the determination, by engineers of the Bureau of Internal Revenue, of the proper amortization allowance, the estimated value to the taxpayer of the property in terms of its actual use or employment in his going business, shall be as of the time of such determination. In the final determination, the amount of the

amortization allowance will be ascertained upon the basis of stable post-war conditions under regulations to be promulgated when these conditions become apparent.

Special record of all property falling in (1) above, must be preserved by the taxpayer, and the Commissioner must be promptly notified (a) if, after having been in good faith permanently discarded or dismantled, property shall in any case be restored to use because of conditions not foreseen or anticipated at the time it was discarded; or (b) of the selling price, if sold.

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